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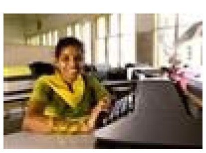
Microfinance - What is it?



Microfinance is the provision of financial services to low-income clients, including consumers and the self-employed, who traditionally lack access to banking and related services.

A lot of microfinance focuses on providing relatively small loans to very poor people who have no access to formal banking services. They may use such loans to start income generating projects and small businesses.

However, savings are also a very important part of microfinance services. Poor people save in order to reduce their vulnerability to hardship. And they need to save money for the future -- their children’s education, a business start-up and major life events, such as marriage or a funeral. They need access to secure saving services, adapted to their needs.

Other financial services such as insurance, business and home loans also play an important role in the development of communities. Not everyone is or wants to be an entrepreneur, but everyone needs access to financial services in order to participate fully in economic life.

United Nations’ definition of microfinance. Microfinance can be broadly defined as the provision of small-scale financial services such as savings, credit and other basic financial services to poor and low-income people. The term “microfinance institution” now refers to a wide range of organizations dedicated to providing these services and includes non-governmental organizations, credit unions, co-operatives, private commercial banks, non-bank financial institutions and parts of state-owned banks.

Women and money. Women make up a disproportionate percentage of the poor. It’s well recognized that the world’s poorest households tend to rely more heavily on income generated by women.

Microfinance is at times referred to as “women’s finance.” Research has shown that women clients of microfinance institutions are more inclined than men to invest in their families’ health and education. Moreover, money is power – no matter where you call home. Poor women who gain access to microfinance when no other financial services are available to them enhance their status in their communities and in their families.

Women clients differ from men clients in their goals and constraints. They often require distinct loan, savings and insurance products. Financial institutions need to be intentional about meeting the unique microfinance needs of women or risk continued marginalization of this client base.

What about Canadian microfinance?. Although Canadian banks have products and services in place to promote access to banking services to low-income Canadians, such as basic banking services and small scale financing, many Canadians go without basic financial services. Why is this so, and what can we do about it?

This site will help you understand some of the issues and discover solutions. All over Canada, not-for-profit groups known as “community investment funds” help women and men who are denied credit by commercial financial institutions obtain the loans they need to get on their feet. Peer lending groups and other innovative programs are used all over the country to help Canadians help themselves when other doors are closed. And some financial institutions, notably credit unions, also offer microfinance programs.

Getting a business loan isn't all about proven profitability (Bill Girard, Investment Manager, Ecotrust Canada Capital)

What do you do if you can’t point to proven profitability as one of the strengths of your business loan application? Many small business owners, in fact, face this dilemma when they have to approach a lender without being able to present a history of profitability.

I always appreciate it when a loan applicant acknowledges the facts of the matter—be it operating losses or working capital shortages—and can present the fundamental strengths of their application. These strengths might include a sound business model, a strong management team, adequate collateral, and a solid financial projection. An astute lender can and will look beyond a financial statement’s “red ink” and “conventional financial ratios” to determine whether a loan application warrants investment.

Over my many years of lending to small businesses, I have consistently found that it’s certainly not proven profitability, high net worth or massive amounts of collateral that determine the strengths of a loan application. I look as much at indicators such as trends in sales and market share, demonstrated management competencies, and of course supportable income statement projections. I’m looking for elements that allow me to conclude whether or not this is a financially sound business opportunity in the future. Here’s some advice: Do your homework and come to a lender well organized. Present important documents such as financial statements, a business plan or summary of your business, and written details of the program to be financed. Come ready to answer questions, especially difficult ones. Avoid pie-in-the-sky numbers that are very difficult to substantiate. If you don’t know the answer, don’t wing it. Say you will get back with more details later.

Don’t expect your lender to take the time to seriously consider your application if you haven’t properly prepared yourself. By presenting your business in an organized fashion and responding quickly and thoroughly to questions, you’ll give lenders a glimpse of how you might be running your business.

At Ecotrust Canada Capital, most of our loan applicants don't come to us with stellar balance sheets or high personal net worth. And I have to admit that sometimes it takes "thinking outside the box" to structure a loan that fits the needs of both the lender and the borrower. But time and time again we make loans that are based on projected, not past, profits. We also consider the character of our clients. This may sound old-fashion but it continues to work for small business lending.

How do small businesses correctly calculate their working capital needs? (Bill Girard, Investment Manager, Ecotrust Canada Capital)

Early stage businesses, especially small to medium-sized enterprises, quickly learn the importance of having sufficient working capital to support growth. Why then do so many fall short of doing sufficient analysis to determine their working capital needs?

Their analysis is often limited to simply adding up the cost of a few months of variable costs along with several months of overhead costs such as rent, insurance, utilities and concluding that this total is how much working capital they need. My experience is that most entrepreneurs underestimate their working capital needs. This leaves them exposed to unanticipated, but in fact avoidable, shortages in cash in the future.

Working capital needs are based upon a number of factors. These include but may not be limited to such things as:

* the production cycle of your business--how long it takes you to turn inputs into marketable products;
* how fast your inventory "turns over" or is converted into sales;
* the payment terms you provide your customers and the credit terms you have with your suppliers.

An effective method for determining working capital needs is to prepare a cash budget. This is essentially a spreadsheet, normally prepared for a 12-month period, laying out in detail the projected monthly inflow and outflow of cash for the business.

It's important to remember that a cash budget focuses on the monthly flow of cash, not just monthly sales and expenses. Effectively projecting sales and expenses is great. But when will you collect the cash from these sales and when will you need to use your cash to pay for expenses? These are critical questions.

Many businesses that are profitable can run into problems because they have insufficient working capital with which to operate and grow. When done properly, a cash budget allows business owners to see if and when they will have monthly shortages of cash.

Knowing this in advance of speaking to your business lender makes you better prepared to discuss your lending needs. And lenders like loan applicants who come well prepared to seek financing. But more importantly you will be better prepared to manage your cash resources and your growth.

With many of my clients, I have found a cash budget to be one of the most useful tools they can have for the successful operation of their business. This is why I often take the time in the loan application process to assist business owners in preparing a proper cash budget.

Securing a loan isn't just about finding the lowest rate possible (Bill Girard, Investment Manager, Ecotrust Canada Capital)

Certainly every borrower wants the lowest rate of interest they can obtain. However, when it comes to securing business financing it is important not to focus just on the lowest rate, writes Investment Manager Bill Girard. Ignoring other factors could be detrimental to your business health. The interest rate is only one element of a loan. Others include the amount you are able to borrow, the size of your monthly payment, the length of the payback period and type of collateral. Is putting your house up as collateral part of the picture? These and other terms and conditions of any business loan should be considered along with the interest rate charged. In fact, it’s very possible that taking the loan with the lowest rate of interest may not be your best option. What do I mean by this?

First, let’s look at some numbers regarding rates and monthly payments. If you are borrowing $50,000 and one lender’s rate is 1.5 percentage points above that offered by another lender what does this mean for your business? If both loans are structured to be paid off just as quickly—let’s say over 36 months—you will pay approximately $35 per month more for the higher rate loan or $420 more each year. If however, the higher rate lender is prepared to let you pay the loan off more slowly—over 48 months instead of 36—you will actually pay $310 less per month or about $3,720 less each year with the higher rate. Understand that you will pay more in total interest over the term of the loan with slower repayment (longer amortization). This is simply because the loan balance on which the interest is charged is outstanding longer. However, if keeping your monthly payments lower is important then going with the lender that is charging the higher rate, but with the longer amortization, may be the better option. One benefit of the lower payment is that you have more discretionary cash to work with and invest in your business. If you are at a stage of business growth where this is important then the higher rate and lower monthly payment loan may be preferred.

Another consideration is the amount you are able to borrower from different lenders. Let's assume you conclude that having more capital at your disposal is desirable. Then being able to borrow more from a lender that is prepared to provide you more cash is clearly worth serious consideration. The increased profits you could generate from having more money to invest in your business could offset the marginal cost of a higher rate loan.

Many small business owners don't examine their lending strategies at this level. They typically go to their familiar financial institution, take that lender's stated terms, and conclude "that's all that's available". Prudent financial management for your business should compel you to "get a second opinion" and weigh the advantages and disadvantages of alternative lenders. Simply getting the lower interest rate may not be in your best interest

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Collateral

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Collateral definition

Collateral is an asset of value that a borrower pledges as a guarantee that a loan will be repaid.

Collateral is a tangible or intangible asset pledged to secure a loan. If the borrower stops repaying the loan, the lender can seize and sell the collateral to get their funds back.
"The most common example that people can relate to is a residential mortgage, where a bank loans money but takes a mortgage on the home," says Mark Fruehm, Senior Manager, Underwriting and Credit Risk Management at BDC, who analyzes and approves business loans.

"The home is the collateral. Similarly, for business loans, collateral is anything that has value and can be sold in order to recoup what is owing on a loan."

Anything that a lender is financing, if it has value, it is most likely part of the securities package and therefore becomes the collateral.

Simon Rivest
Senior Manager, Underwriting and Credit Risk Management, BDC

What does collateral mean?

Collateral is an asset that has a specific value and which a borrower can offer as security for a loan to ensure the lender gets their money back if the loan isn't repaid.

It can include tangible items, such as a building or equipment, or intangible assets, such as intellectual property.

The specific collateral pledged for a loan is typically the item being financed. For example, if a company gets a loan to buy a $1 million building,

the building would generally be put up as collateral and part of the securities package for the loan.
“Anything that a lender is financing, if it has value, it is most likely part of the securities package and therefore becomes the collateral in most cases,” says Simon Rivest, a Senior Manager, Underwriting and Credit Risk Management at BDC. “If you're financing a piece of equipment, the equipment will be used as collateral, and if you’re financing real estate, the real estate will become the collateral.”

Collateral isn’t the same as security

The term collateral is sometimes used interchangeably with security, but they are not the same. Collateral is a pledged asset of value, while security is a broader term referring to all the elements the lender uses to safeguard the loan. These include the collateral as well as legal protections and requirements.

Examples of securities

Personal guarantees—A personal guarantee is a commitment by a business owner or shareholder to repay the loan personally if the company fails to do so. Some lenders may require the personal guarantee to include specific assets, such as a home or personal investments. These assets are then considered collateral for the loan.

Other lenders (including BDC) use personal guarantees as security for loans. They do not as a rule list any specific assets in the guarantee. “Such a personal guarantee is a moral commitment to repay the loan,” Rivest says.

Corporate guarantees—A corporate guarantee is a pledge by an affiliated business to repay a loan if the borrower can’t do so. The guarantee could include a specific asset that is pledged as collateral.
Lenders often require personal and corporate guarantees as part of the broader securities package for a loan, especially if the loan amount is greater than the value of the collateral. For example, a lender may agree to loan a company $1 million to buy a building, but the building may be worth only $750,000. In this case, the lender would likely require a personal or corporate guarantee to cover the difference of $250,000.

“If there’s a shortfall and we can’t fully cover the loan amount based on the collateral, then we would look at a guarantee to cover the difference,” Fruehm says.

Covenants—A securities package can also include covenants, which are terms and conditions the borrower must follow. These may involve maintaining certain financial ratios or committing to not take on more debt.

What types of loans require collateral?

Most term, demand and operating loans require collateral. The collateral for term and demand loans is usually the asset being financed. For an operating loan (also known as a line of credit), which is used to finance day-to-day expenses, the company's accounts receivable and inventory typically represent the collateral.

The type of loan not usually requiring collateral is a working capital loan. These loans are used to finance a business activity, such as hiring a salesperson, creating a website or developing a strategic plan, and not for buying a tangible asset.

"Working capital loans are usually used to buy things you can't really collateralize," Fruehm says. "In these cases, the lending decisions are based more on the cash flow of the company and the finances of the shareholders or owners."

Working capital loans don't typically require collateral but, as part of the security for the loan, the borrower is usually required to provide a personal and/or corporate guarantee.

What is the difference between a secured and unsecured loan?

A secured loan involves collateral pledged as security for the loan. An unsecured loan doesn't involve the pledge of any collateral. One example would be a working capital loan.

That said, an unsecured loan still usually requires security in the form of a personal and/or corporate guarantee.

What can you use as collateral?

Collateral for a loan is usually the asset being bought with the loan. For example, the collateral for a vehicle loan would typically be the vehicle itself.

Collateral can be tangible or intangible assets. Examples of the former may include:

- buildings
- equipment and machinery
- vehicles
- inventory (usually raw material and finished goods)
- computer hardware
- accounts receivable

Examples of intangible assets used as collateral:

- computer software
- intellectual property, such as patents, copyrights, trademarks and trade secrets
- contracts, licenses, franchise agreements and leases
- securities and bonds

What can't be used as collateral?

Any asset with value can in theory be used as collateral, but some lenders' rules may differ for what they accept. For example, for personal guarantees, some lenders require a specific asset to be pledged as collateral, while others don't.

As well, some lenders accept financial assets to be used as collateral, while others don't. (BDC does not accept financial assets as collateral.)

Obtaining repayment from seizing and selling collateral is not how a lender wants to be repaid. It is a final recourse.

Mark Fruehm
Senior Manager, Underwriting and Credit Risk Management, BDC

What happens to your collateral if you can't pay back a loan?

If a business stops making payments required by the loan agreement, the lender can start proceedings to take ownership of whatever was pledged as collateral and then sell it to generate cash to cover the loan.

"The lender is enforcing what you've agreed to, and taking the collateral," Fruehm says. "They will try to generate cash out of those items, with the aim being to pay as much of the loan back as possible."

If the proceeds don't cover the outstanding loan balance, the lender then typically looks to the personal or corporate guarantee to cover the difference.

Missed payments are investigated

When a borrower misses several loan payments, the lender may assign the account to a special department that investigates the situation further and tries to work something out with the borrower to resume payments.

"Is it a temporary cash crunch?" Rivest asks. "Maybe there was a fire at their biggest client's plant. Sometimes they just need a break from the repayment, and we can allow a postponement or do a quick loan to help

with a temporary situation. Or sometimes you investigate and end up seeing a business coming to an end."

In the latter case, an insolvency trustee is typically hired to coordinate an orderly and fair selling off of the company's assets, maximizing value for lenders, employees and others to whom the business has obligations.

Seizing assets is a last resort

If a company ends up going into receivership or bankruptcy, the various creditors are paid out depending on their registered position or hierarchy. Secured lenders (those with a loan backed by collateral) are generally at the top of the hierarchy above unsecured lenders; but the hierarchy can vary by jurisdiction and be based on the terms of debt and other agreements made between the lenders.

"Determining the order of events and who has access first and to which assets becomes a legal matter," Rivest says.

"In these situations, it's crucial for the main lenders to collaborate and maximize the value, as a quick withdrawal of assets by one lender can impact the overall value for everyone. Various scenarios can arise, but seizing and selling assets is generally considered a last resort after efforts have been made for the business to maintain operations."

Next step

To calculate the costs of a business loan and a monthly amortization schedule, use BDC's free Business loan calculator.

Related definitions

- Borrower
- Lender
- Loan

Find out more in our glossary
